

VZCZCXRO0152
PP RUEHCHI RUEHDT RUEHHM RUEHNN
DE RUEHJA #1940/01 2950318
ZNR UUUUU ZZH
P 210318Z OCT 08
FM AMEMBASSY JAKARTA
TO RUEHC/SECSTATE WASHDC PRIORITY 0366
INFO RUEATRS/DEPT OF TREASURY WASHDC PRIORITY
RUCPDOG/USDOC WASHDC 1540
RUCNASE/ASEAN MEMBER COLLECTIVE
RUEHKO/AMEMBASSY TOKYO 2622
RUEHBJ/AMEMBASSY BEIJING 5508
RUEHBY/AMEMBASSY CANBERRA 3176
RUEHUL/AMEMBASSY SEOUL 5025
RHEHNSC/NSC WASHDC
RUEAIIA/CIA WASHDC

UNCLAS SECTION 01 OF 02 JAKARTA 001940

SENSITIVE
SIPDIS

DEPARTMENT FOR EAP/MTS, EAP/EP, EEB/IFD/OMA, E
TREASURY FOR M.NUGENT AND T.RAND
COMMERCE FOR 4430 BERLINGUETTE/KELLY
DEPARTMENT PASS FEDERAL RESERVE SAN FRANCISCO FOR CURRAN
DEPARTMENT PASS EXIM BANK
SINGAPORE FOR S. BAKER
TOKYO FOR MGREWE
USDA/FAS/OA YOST, MILLER, JACKSON
USDA/FAS/OCRA CRIKER, HIGGISTON, RADLER
USDA/FAS/OGA CHAUDRY, DWYER
USTR WEISEL, EHLERS

E.O. 12958: N/A
TAGS: [EFIN](#) [ECON](#) [ETRD](#) [EINV](#) [ID](#)

SUBJECT: Bracing for Longer-Term Fall-Out from the Financial Crisis

11. (SBU) SUMMARY: Indonesian financial officials and private-sector economists are bracing for longer-term negative impacts of the current global financial crisis. The Yudhoyono administration continues to take comprehensive action designed to minimize the impacts of the crisis on the real economy, including a new regulation establishing a Financial System Safety Net to establish a legal basis for government and Bank Indonesia (BI) officials to provide emergency financing facilities during a financial crisis. Separately, a possible government attempt to bail out the Bakrie Group may undercut the very market confidence the government is attempting to build (see septel). The risk that a serious economic slowdown will result in a current account deficit that will negatively impact capital flows and put pressure on the currency remains the key concern of both the government and the private business sector. One observer noted, only half-jokingly, that Indonesia must now compete for needed capital with the newest emerging market -- the United States. END SUMMARY.

ENGAGING WITH INDONESIAN "MODERNIZERS" ON
FINANCIAL MARKET TURMOIL
- - - - -

12. (U) At an October 15 discussion convened by the Indonesian "Modernisator" reform organization on the impact of the financial crisis, the main message was the same: Indonesia would not be able to avoid the fall-out from the current global financial crisis, especially since the crisis coincides with a significant drop in the prices of many of Indonesia's main commodity exports. However, Indonesia may be able to limit negative impacts by avoiding panic in the financial sector, maintaining a sound budget, embracing good policies to attract greater investment and deepening the domestic bond market.

13. (U) One speaker, Dr. Raden Pardede, Chairman of Indonesia's Financial System Stability Forum, provided a sharp critique of the "new financial system" and financial innovations which contributed to the U.S. financial crisis by providing the wrong incentives, including short-term bonuses and golden parachutes. He argued that

implicit credit subsidies had distorted the sub-prime mortgage market and encouraged speculative greed/mania, and that loose monetary policy and lax supervision allowed the problem to grow. He noted that the U.S. housing market correction and the resulting liquidity crunch, with massive deleveraging and fear/panic in international markets, will impact Indonesia by lowering growth due to reduced exports, increasing competition for and raising the costs of credit as capital moves away from emerging markets into "safe havens", and reducing prospects for obtaining capital through initial public offerings and bond issuances. These developments are likely to lead to current account and balance of payments pressures which would weigh on exchange rates and constrain monetary policy.

¶4. (U) Pardede briefed on the many steps the Indonesian government had already taken to respond to the crisis and outlined remaining tools in its arsenal, including possible interest rate cuts and capital injections into the banking system. Pardede characterized international efforts to date as lacking in sufficient leadership. He said the next steps to the crisis will include counter-cyclical fiscal policy, balancing growth and stability, improving household balance sheets, creation of a new regulatory regime to limit leverage and off-balance sheet accounting and to strengthen supervision. Lessons for the future included the need to act decisively and avoid denial. On the last point, he cited favorably approaches taken by Sweden and the U.K. vs. approaches taken by Japan and the U.S.

¶5. (U) Dr. Chatib Basri, Director of the Institute for Social and Economic Research and government advisor, expressed his hope that "bad times will make good policies." He urged Indonesia to improve its investment climate to attract additional foreign direct

JAKARTA 00001940 002 OF 002

investment and to begin to address supply constraints such as critical infrastructure development.

¶6. (U) Purbaya Yudi Sadewa, Head of Danareksa Research Institute, provided additional insights into the contractionary effects of the government account, which rose to over IDR 200 trillion in BI in August 2008 due to slow budget disbursement and significant revenue over-performance. He advised that Danareksa's Early Warning System, which includes leading economic indicators and confidence levels, showed slowing domestic demand and forecast an economic slowdown, although not a sharp one. He noted that eroded purchasing power, higher interest rates due to monetary tightening, and tighter liquidity were contributing to a slowdown in the domestic economy.

ECONOMIST VIEWS: BOND AND CURRENCY MARKETS MATTER MOST

¶7. (SBU) In a separate conversation, Basri told Embassy on October 14 that the Indonesian government remains most concerned about developments in the bond and currency markets. Government officials are closely monitoring the government bond market as increased risk aversion has weighed on the prices of emerging market bonds, driving up the costs of financing budget deficits. (Note: In the past year, the yield on Indonesia's benchmark ten-year government bond has increased by more than 600 basis points.) According to Basri, the government recognizes developments in the stock market will be largely driven by the private sector, although the government can boost demand at the margin for shares by encouraging share-backs.

NEW FINANCIAL SYSTEM SAFETY NET: BID TO PREVENT REPEAT OF BI LIQUIDITY SCANDAL

¶8. (SBU) Although the Yudhoyono administration had sought legislation to provide a legal umbrella for government and Bank Indonesia officials to act to prevent or manage a financial crisis, current market conditions and the anticipated lengthy process for securing passage of financial system legislation prompted SBY to issue a regulation (Perpu #4/2008) in lieu of legislation on October 15. The regulation provides guidelines and mechanisms for extending liquidity or injecting capital into banks or non-bank financial institutions of systemic importance; authorizes the government to

provide funds from the state budget (with agreement from the parliament) or from issuance of State Treasury notes; establishes a Financial System Stability Committee, consisting of the Finance Minister and Bank Indonesia Bank governor, to ensure coordination; authorizes Bank Indonesia to take management control of banks receiving liquidity assistance; and authorizes provision of fiscal and/or administrative incentives to encourage financially sound firms to take over unsound financial institutions, thereby minimizing costs to the state.

19. (SBU) The business community, which had advocated for a clear legal basis authorizing officials to take needed action in the event of a financial crisis, welcomed issuance of the new regulation. It is intended to prevent a repeat of the misuse of Bank Indonesia Liquidity Assistance provided in the wake of the Asian Financial Crisis, which has led (thus far) to the prosecution of at least one former Bank Indonesia governor and several other BI officials.

HUME